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DEVELOPING COUNTRIES

Switching Some Multilateral Loans to Grants Would Lessen Poor Country Debt Burdens

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Abstract
I am pleased to be here today to discuss the impact that switching some loans to grants would have on poor countries debt burdens. In July 2001, President Bush proposed that the World Bank and other development banks replace 50 percent of future loans to the worlds poorest countries with grants. A goal of this proposal was to relieve poor countries long-term debt burdens. The presidents grants proposal would mean a significant change for multilateral institutions such as the World Bank, which traditionally use low-cost loans to deliver development assistance. The World Bank estimates that this controversial proposal would result in a financial loss of $100 billion over the next 40 years.

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the impact that switching some loans to grants would have on poor countries' debt burdens.

In July 2001, President Bush proposed that the World Bank and other development banks replace 50 percent of future loans to the world's poorest countries with grants. A goal of this proposal was to relieve poor countries' long-term debt burdens. The president's grants proposal would mean a significant change for multilateral institutions such as the World Bank, which traditionally use low-cost loans to deliver development assistance. The World Bank estimates that this controversial proposal would result in a financial loss of $100 billion over the next 40 years.

As discussed in our recent report,[1] we found that the proposal to shift 50-percent of multilateral institutions' loans to grants (1) would help poor countries reduce their debt burdens, and (2) would cost the World Bank $15.6 billion, which could be financed through relatively small increases in donor contributions.

In conducting our work, we used World Bank and International Monetary Fund (IMF) analyses that included detailed country-specific economic forecasts and projections of the financial implications of switching from loans to grants. However, we based our analysis on historical export growth rates for 10 poor countries,[2] in contrast to the highly optimistic rates assumed by the World Bank and IMF. We also built on prior work that examined World Bank and IMF 20-year projections on poor countries' debt burdens. The World Bank and the IMF reviewed and provided detailed comments on this earlier analysis. However, we were unable to discuss our new findings with World Bank and IMF officials because the Department of the Treasury did not approve our access to officials of those institutions. Treasury officials were concerned that our work would interfere with ongoing negotiations to refinance the World Bank's International Development Agency (IDA).

[1] See United States General Accounting Office, *Developing Countries: Switching Some Multilateral Loans to Grants Lessens Poor Country Debt Burdens*, GAO-02-593 (Washington, D.C.: April 19, 2002).

[2] The 10 countries chosen—Benin, Bolivia, Burkina Faso, Ethiopia, Mali, Mozambique, Nicaragua, Tanzania, Uganda, and Zambia—are geographically dispersed, represent a wide range of economic conditions, and receive about two thirds of internationally provided debt relief.

Summary

The Administration's proposal to replace 50 percent of multilateral loans with grants would lessen poor countries' debt burdens and increase their ability to repay future debt. Our analysis found that under the grants proposal 4 of the 10 countries we analyzed would be debt sustainable[3] for 20 years and 2 other countries would be debt sustainable for most of that period. Furthermore, the grants proposal is more effective in promoting debt sustainability than proposals to forgive 100-percent of old multilateral debt. Any advantage of the 100-percent debt forgiveness proposal is eliminated after 7 years because poor countries would accumulate new debt that will become unsustainable.

We estimate that the financial loss of the 50-percent grants proposal is $15.6 billion. Our estimate differs from the World Bank's projected loss of $100 billion over 40 years because we adjusted for the impact of inflation and the investment income that could accrue over time. We found that the World Bank could fully finance the grants proposal if donors increase their contributions by 1.6 percent a year, which is less than the expected rate of inflation over the next 40 years.

Background

During the 1970s and 1980s, many low-income countries sharply increased their external borrowing, mostly from other governments or multilateral institutions. During this period, the price of primary commodities tended to be high, contributing to optimistic export growth projections on the part of developing countries, which encouraged them to overborrow. By the end of 1997, the total external debt of the 42 countries classified as heavily indebted poor countries had a face value of more than $200 billion. Much of this debt was not being repaid or was repaid only with the support of donors. In 1996, the Heavily Indebted Poor Countries (HIPC) initiative was created to provide debt relief to these poor countries.[4] In 1999, the World Bank and IMF agreed to enhance the HIPC initiative by doubling the estimated amount of debt relief to over $28 billion for 32 of

[3]The World Bank and International Monetary Fund consider a country to be "debt sustainable" if the ratio of a country's debt (in present value terms) to the value of its exports is 150 percent or less.

[4]Efforts to relieve the debt burdens of poor countries have concentrated on the external debt of these countries. Thus, debt sustainability is defined in terms of repaying debt owed to external creditors, with export earnings considered an important source of revenue for repaying this debt.

these countries. According to the World Bank and IMF, countries that receive debt relief under the HIPC initiative are projected to be debt sustainable. However, we found that the initiative is not likely to help recipients achieve debt sustainability because the World Bank and IMF assume that these countries will achieve export growth rates more than double their historical levels.[5]

Two key factors make it difficult for poor countries to achieve the high export growth rates assumed by the World Bank and IMF. First, most of the 10 countries we analyzed rely on one or two primary agricultural and/or mineral commodities for a significant portion of their foreign exchange earnings. However, the prices of these commodities have been on a downward trend in recent years, which impairs these countries' ability to increase their export income. Second, development professionals and multilateral aid organizations recognize that the HIV/AIDS pandemic is a major threat to the growth rates of many poor countries. The governments of these countries will need to divert funds from economic growth initiatives to cover dramatically increasing health care costs, rising labor costs, and productivity losses in key export sectors.

[5]See GAO-02-593 and United States General Accounting Office, *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*, GAO/NSIAD-00-161 (Washington, D.C., June 29, 2000).

Shifting Some Multilateral Loans to Grants Would Have a Positive Impact on Debt Sustainability for Poor Countries

Grants Can Help Some Countries Reach Debt Sustainability

A shift from loans to grants would benefit all countries' ability to repay their future debt. If grants were to replace 50 percent of loans, the debt-to-export ratios of all 10 countries we analyzed would improve (see table 1). Their debt-to-export ratios are projected to decline from an average of 432 percent under the historical baseline to an average of 235 percent under the 50-percent proposal. Under the historical baseline, only two countries—Mali and Mozambique—are debt sustainable. Two additional countries—Benin and Uganda—would become debt sustainable over the 20-year period under the 50-percent grants proposal. In addition, Nicaragua and Tanzania are either debt sustainable or nearly so for a considerable portion of the 20-year period under the grants proposal.

Table 1: Projected 20-Year Debt-to-Export Ratios under Three Scenarios

Country	Historical baseline (percent)	Impact of 50-percent grant proposal (percent)	Impact of full forgiveness of old multilateral debt (percent)
Benin	168	**99**	**142**
Bolivia	668	393	649
Burkina-Faso	713	377	648
Ethiopia	572	328	502
Mali	**62**	**42**	**44**
Mozambique	**153**	**78**	**140**
Nicaragua	377	*210*	358
Tanzania	434	*239*	429
Uganda	339	**125**	324
Zambia	837	457	784
Average	**432**	**235**	**402**

Note: Countries projected to be debt sustainable are in bold. That is, their debt-to-export ratio is near or below 150 percent. Countries that are nearly debt sustainable are in italics. GAO's projections of debt sustainability assume that countries receive debt relief under the HIPC initiative and grow at historical export growth rates.

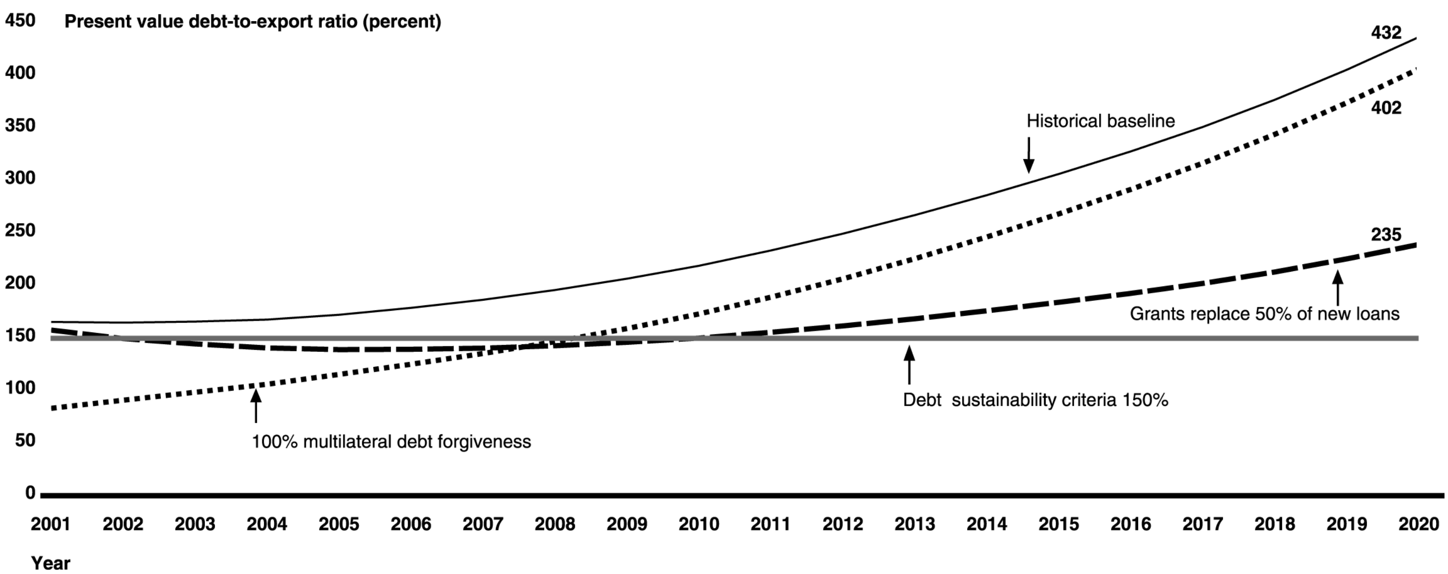
Source: GAO analysis.

The 50-percent grants proposal does not help every country become debt sustainable over the 20-year projection period, however. Based on our analysis, Bolivia, Burkina Faso, Ethiopia, and Zambia will not be debt sustainable at the end of the 20-year period, even if they receive 50 percent of their future assistance in the form of grants. The benefits from 50-percent grants are not sufficient to lessen the debt burdens of these four countries because they are projected to borrow substantial additional resources to compensate for insufficient revenue from exports.

Grants Proposal Contributes More to Debt Sustainability Than Full Forgiveness of Old Multilateral Debt

The grants proposal is also more effective in promoting debt sustainability than proposals to forgive 100-percent of old multilateral debt. Our analysis shows that debt-to-export ratios decline from an average of 402 percent under the 100-percent debt forgiveness scenario to an average of 235 percent under the 50-percent grants proposal. Long-term debt sustainability under 100-percent debt forgiveness is in fact only slightly improved over the historical baseline. Forgiveness of old multilateral debt would improve countries' debt ratios only for the first 7 years. After that, the advantage of this plan is eliminated because these countries are projected to accumulate a substantial amount of new debt that will quickly become unsustainable (see fig. 1).

Figure 1: 20-Year Debt Sustainability Projections for 10 Poor Countries



Note: The lines for the three scenarios represent the annual average debt ratios for the 10 countries.
Source: GAO analysis.

Grants Proposal Can Be Financed through Relatively Small Increases in Donor Contributions

Shift to 50-Percent Grants Would Reduce World Bank Concessional Resources

The proposal to shift 50 percent of multilateral loans to grants would result in a revenue loss to the World Bank. We estimate the present value of foregone repayments from poor countries to the World Bank to be approximately $9.73 billion over the next 40 years. The total financial loss of the 50-percent grants proposal is approximately $15.6 billion, since the $9.73 billion would have accrued an additional $5.82 billion in investment income to the World Bank. This amount represents about 8 percent of the $120.2 billion in present value terms that the World Bank expects to commit to poor countries over this 40-year time frame.

The World Bank has reported that the grants proposal would result in a $100 billion loss to IDA over 40 years—about $59 billion of this loss stems from foregone repayments, with the remaining $41 billion derived from foregone interest earnings. However, the World Bank's methodology assumes that the value of a dollar received today is worth the same as a dollar received 40 years from now. This assumption does not properly account for the impact of inflation and the investment income that could accrue over time.

Small Increases in Donor Contributions Can Finance the Grants Proposal

Our analysis shows that the 50-percent grants proposal could be fully financed through small increases in contributions from donor countries over what is currently projected. If donor countries were to increase their annual contribution to IDA by 1.6 percent over 40 years, they would fully finance the 50-percent grants proposal. An annual increase in donor contributions of 1.6 percent would be less than the expected rate of inflation, which is projected to be 2.3 percent over this time period. Donor contributions to IDA are expected to increase by 13.4 percent over the next 3 years, with U.S. contributions expected to grow by more than 18 percent.

Alternative options for making up the foregone revenue from the 50-percent grants proposal are fairly limited. The World Bank finances its concessional loan program through International Bank for Reconstruction and Development (IBRD) contributions, investment income, and loan repayments, in addition to donor contributions. The World Bank is unlikely to recoup the lost revenue from IBRD contributions because any increase in contributions to IDA from IBRD would come at the expense of other priorities such as maintaining sufficient reserves for lending to middle income countries. The World Bank would have difficulty significantly increasing its investment income without increasing the risk of its investments beyond what it considers prudent. Furthermore, it cannot increase loan repayments from poor countries without effectively nullifying any improvement to their debt sustainability that would accrue from the 50-percent grants proposal.

Mr. Chairman and Members of the Subcommittee, this concludes my prepared statement. I will be happy to answer any questions you or other Members may have.

Contacts and Acknowledgments

For addition information about this testimony, please contact Joseph Christoff at (202) 512-8979. Individuals making key contributions to this testimony included Thomas Melito, Anthony Moran, Bruce Kutnick, R.G. Steinman, Ming Chen, Jeffery Goebel, and Lynn Cothern.